

SELL

TP: Rs 740 | ▼ 8%

MPHASIS

| IT Services

| 14 May 2020

HP-DXC business losing steam; downgrade to SELL

Mphasis (MPHL) reported a satisfactory Q4 on the back of (1) 1.5% QoQ/11.1% YoY CC revenue growth, (2) stable 16.3% EBIT margins, and (3) healthy deal wins. But HP-DXC business declined 2.8% QoQ and was also negative YoY for the first time in 12 quarters. Q1FY21 is guided to be weak due to Covid-19. In our view, management's target of stable margins in FY21 looks difficult. We cut FY21/FY22 EPS 21%/10%, revise our Mar'21 TP to Rs 740 (vs. Rs 1,050) and downgrade to SELL (from ADD) on HP-DXC vulnerability and pandemic-related volatility.

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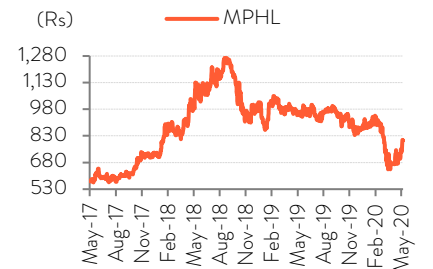
Decent Q4 but DXC/HP channel disappoints: Q4 revenue increased 1.5% QoQ CC and 11.1% YoY CC (0.2% QoQ and 10.8% YoY in dollar terms). The DXC/HP channel, however, saw a sharp 2.8% QoQ decline in USD revenue on the heels of a slowdown over the past three quarters. MPHL's EBIT margin was stable for the quarter, standing at 16.3% (+10bps QoQ), within the guided range of 15.5-17%. Akin to industry peers, TCV was strong at US\$ 201mn, growing 37% YoY.

Ticker/Price	MPHL IN/Rs 803
Market cap	US\$ 2.0bn
Shares o/s	186mn
3M ADV	US\$ 3.9mn
52wk high/low	Rs 1,018/Rs 630
Promoter/FPI/DII	52%/29%/14%

Source: NSE

DXC revenue commitment nearing an end: DXC had committed minimum revenue of US\$ 990mn over five years when it sold its stake in MPHL to Blackstone in 2016. This commitment ends in Sep'21, leading to a diminishing margin of safety for the HP/DXC business (~26% gross revenue share in Q4 and 27% in FY20). MPHL's management stated that US\$ 300mn is pending over the remaining six-quarter term, implying a quarterly run-rate of US\$ 50mn vs. US\$ 72mn of DXC revenue or US\$ 82mn of HP-DXC revenue for Q4.

STOCK PERFORMANCE



Source: NSE

EBIT margin stability unlikely: Management expects the Jun'20 quarter to be weak due to Covid-19, with growth recovery from Q2FY21. MPHL is targeting operating margin stability in FY21 which we believe looks unlikely considering pandemic-led unknowns and weak growth dynamics.

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20P	FY21E	FY22E
Total revenue (Rs mn)	65,459	77,311	88,436	91,984	1,00,184
EBITDA (Rs mn)	10,626	13,240	16,505	15,276	18,918
Adj. net profit (Rs mn)	8,507	10,734	11,849	9,837	12,523
Adj. EPS (Rs)	44.1	57.7	63.7	52.8	67.3
Adj. EPS growth (%)	14.9	30.9	10.4	(17.0)	27.3
Adj. ROAE (%)	14.6	20.0	21.4	16.2	19.1
Adj. P/E (x)	18.2	13.9	12.6	15.2	11.9
EV/EBITDA (x)	13.7	11.1	9.0	9.8	8.0

Source: Company, BOBCAPS Research

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Earnings call highlights

- The banking and capital markets/insurance verticals grew 3.8%/4.9% QoQ in dollar terms, with Europe leading the way in Q4FY20. MPHL is trying to grow outside of the UK and expects the rest of Europe to be a major growth driver in FY21. Emerging verticals continued to see healthy momentum (+4.8% QoQ). While travel and transportation forms 53% of 'emerging industries', lower exposure to the airlines and hospitality business has minimised shocks from Covid-19.
- At US\$ 201mn, deal wins for Q4 were the highest in the last six quarters. The engagements were broad-based, with 80% coming from new-gen services.
- Final dividend of Rs 35/sh was announced for FY20.
- **Covid-19 impact**
 - 95% of employees are now working from home. Some concerns at BFSI clients led to lower employee migration to the work-for-home model.
 - Reprioritisation of IT budgets has begun and a short-term impact is visible on discretionary spend. MPHL is working with clients to manage the new crisis. Clients are restructuring their business – agility, resilience, cost reduction and digital pivot will dominate tech spends going ahead. Virtual desktop as a service and cybersecurity offerings are seeing increased demand. Digital and contactless edesign are also in demand.

FIG 1 – MAR'20 QUARTER PERFORMANCE

(Rs mn)	Q4FY20	Q4FY19	YoY (%)	Q3FY20	QoQ (%)	FY20	FY19	YoY (%)
Revenue (US\$ mn)	320	289	10.8	319	0.2	1,242	1,106	12.3
Revenue excluding hedging gains/losses (US\$ mn)	320	292	9.7	318	0.6	1,239	1,119	10.8
Revenue	23,462	20,250	15.9	22,767	3.1	88,436	77,311	14.4
Revenue excluding hedging gains/losses	23,476	20,469	14.7	22,694	3.4	88,239	78,194	12.8
Operating Expenditure	19,021	16,846	12.9	18,498	2.8	71,931	64,071	12.3
Cost of revenues	16,591	14,815	12.0	16,228	2.2	62,951	55,734	12.9
as % of sales	70.7	73.2	-	71.3	-	71.2	72.1	-
SG&A expenses	2,430	2,031	19.6	2,270	7.0	8,980	8,337	7.7
as % of sales	10.4	10.0	-	10.0	-	10.2	10.8	-
EBITDA	4,441	3,404	30.4	4,269	4.0	16,505	13,240	24.7
Depreciation	610	200	205.0	575	6.1	2,317	759	205.3
EBIT	3,831	3,204	19.6	3,694	3.7	14,188	12,481	13.7
Other Income	319	273	16.8	172	85.5	967	1,592	(39.3)
PBT	4,150	3,477	19.3	3,866	7.3	15,155	14,073	7.7
Total Tax	618	815	(24.2)	929	(33.5)	3,306	3,339	(1.0)
Adjusted PAT	3,532	2,662	32.7	2,937	20.2	11,849	10,734	10.4
APAT after MI	3,532	2,662	32.7	2,937	20.2	11,849	10,734	10.4
Extra ordinary items	-	-	-	-	-	0	0	-
Reported PAT	3,532	2,662	32.7	2,937	20.2	11,849	10,734	10.4
Reported EPS	18.9	14.3	32.2	15.8	19.6	64	56	13.4

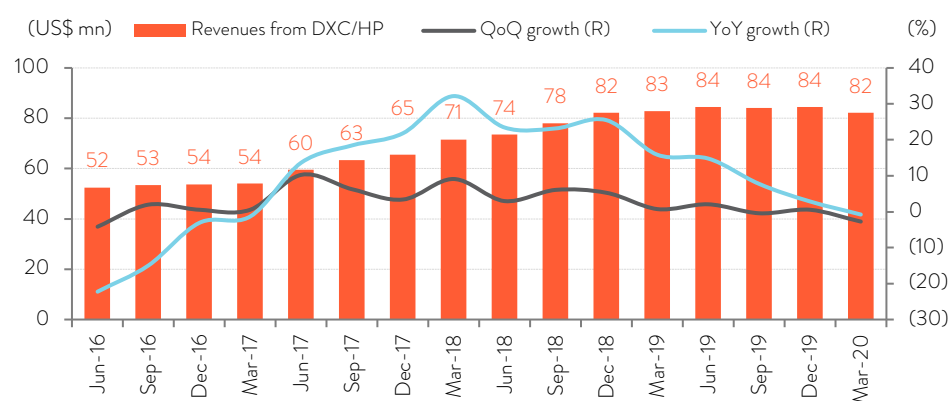
(Rs mn)	Q4FY20	Q4FY19	YoY (%)	Q3FY20	QoQ (%)	FY20	FY19	YoY (%)
Margins (%)			(bps)		(bps)			(bps)
EBITDA	18.9	16.8	210	18.8	20	18.7	17.1	150
EBIT	16.3	15.8	50	16.2	10	16.0	16.1	(10)
EBT	17.7	17.2	50	17.0	70	17.1	18.2	(110)
PAT	15.1	13.1	190	12.9	220	13.4	13.9	(50)
Effective Tax rate	14.9	23.4	(850)	24.0	(910)	21.8	23.7	(190)

Source: Company, BOBCAPS Research

FIG 2 – MAR'20 OPERATING PERFORMANCE

Particulars	Q4FY20 (% Contr.to Revenue)	Growth (%)	
		QoQ	YoY
Revenue by Business Segments (in US\$ terms)			
HP Channel	26	(2.8)	(0.8)
Digital Risk	9	3.7	36.7
Direct Channel (ex-Digital Risk)	65	1.6	11.3
Revenue by verticals (in Rs terms)			
Banking and Capital Markets	45.7	3.8	18.1
Insurance	11.4	4.9	9.2
Information Technology, communication & Entertainment	15.1	(1.0)	0.0
Emerging Industries	27.9	4.8	21.0
Revenue by Service Type (in Rs terms)			
App Maintenance & Other services	31.1	12.6	6.5
App Development	32.9	5.9	20.2
Customer Service	0.7	(42.8)	(33.9)
Service/Tech Helpdesk	5.5	(28.2)	(11.4)
Transaction Processing service	7.9	5.0	45.0
Infra Mgmt services	12.4	(1.5)	11.6
Knowledge Process	9.4	6.4	40.4
IT services-Client Concentration (in Rs terms)			
Top client contribution to revenues	13.0	(4.3)	7.6
Top 5 client contribution to revenues	48.0	3.1	18.3
Top 10 client contribution to revenues	60.0	3.1	15.9
Total Employees	26,398	(3.3)	7.8
Revenue by Project Type			
T & M	72	(100)	(500)
Fixed price	28	100	500

Source: Company, BOBCAPS Research

FIG 3 – DXC-HP BUSINESS YOY GROWTH TURNS NEGATIVE

Source: Company, BOBCAPS Research

Valuation methodology

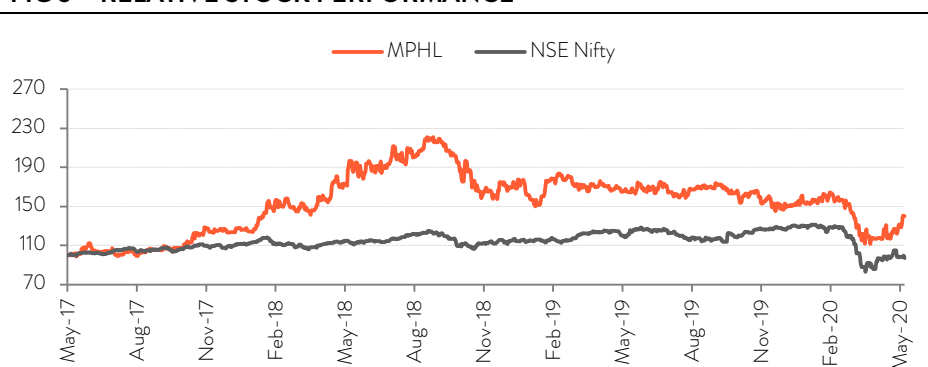
We reduce our FY21/FY22 EPS estimates by 21%/10% and also reset our target FY22E P/E multiple to 11x from 14x as we accommodate uncertainty linked to Covid-19 and a weaker HP-DXC business. Our Mar'21 target price thus stands revised to Rs 740 (Rs 1,050 earlier). Downgrade from ADD to SELL on (1) a diminishing margin of safety as DXC's revenue commitment nears an end, and (2) vulnerability due to high client concentration (25% of revenue from HP-DXC channel wherein DXC is struggling with a weak growth outlook).

FIG 4 – REVISED ESTIMATES

(Rs mn)	FY21E			FY22E		
	Old	New	Change (%)	Old	New	Change (%)
Reported Revenues (US\$ mn)	1,423	1,226	(13.8)	1,580	1,336	(15.5)
YoY (%)	13.7	(1.3)	-	13.8	8.9	-
Revenues (ex-hedging, US\$ mn)	1,423	1,226	(13.8)	1,580	1,336	(15.5)
Revenues	99,612	91,984	(7.7)	1,10,610	1,00,184	(9.4)
EBIT	16,211	12,679	(21.8)	18,162	16,321	(10.1)
EBIT margins (%)	16.3	13.8	-	16.4	16.3	-
Net Profits	12,414	9,837	(20.8)	13,982	12,523	(10.4)
EPS (Rs)	66.7	52.8	(20.8)	75.1	67.3	(10.4)

Source: BOBCAPS Research

FIG 5 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

- In the past, MPHL had suffered adversely due to high HP/DXC channel revenue concentration. Unfavourable changes in HP/DXC and Blackstone portfolio company relationships could pose downside risks to our estimates
- Inability of the company to arrest the sharp decline in Digital Risk revenues, adverse currency movements, and a steep decline in IT spending at other clients could also adversely impact financial performance.

FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20P	FY21E	FY22E
Total revenue	65,459	77,311	88,436	91,984	1,00,184
EBITDA	10,626	13,240	16,505	15,276	18,918
Depreciation	709	759	2,317	2,597	2,597
EBIT	9,917	12,481	14,188	12,679	16,321
Net interest income/(expenses)	0	0	0	0	0
Other income/(expenses)	1,490	1,592	967	437	376
Exceptional items	0	0	0	0	0
EBT	11,407	14,073	15,155	13,116	16,697
Income taxes	2,900	3,339	3,306	3,279	4,174
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	8,507	10,734	11,849	9,837	12,523
Adjustments	0	0	0	0	0
Adjusted net profit	8,507	10,734	11,849	9,837	12,523

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20P	FY21E	FY22E
Accounts payables	0	0	0	0	0
Other current liabilities	10,842	11,687	12,769	13,861	15,096
Provisions	245	3,100	2,242	3,780	4,117
Debt funds	3,898	5,428	12,955	12,955	12,955
Other liabilities	49	28	137	137	137
Equity capital	1,932	1,862	1,865	1,865	1,865
Reserves & surplus	52,883	50,636	56,431	60,938	66,676
Shareholders' fund	54,815	52,498	58,296	62,804	68,542
Total liabilities and equities	69,849	72,741	86,399	93,537	1,00,847
Cash and cash eq.	4,641	6,572	11,484	11,858	16,982
Accounts receivables	8,127	8,620	7,217	11,592	12,626
Inventories	0	0	0	0	0
Other current assets	10,923	21,339	21,596	25,201	27,448
Investments	26,245	13,292	13,257	13,257	13,257
Net fixed assets	1,824	2,113	8,730	7,513	6,419
CWIP	19	406	553	553	553
Intangible assets	17,014	19,585	21,405	21,405	21,405
Deferred tax assets, net	1,056	814	2,157	2,157	2,157
Other assets	0	0	0	0	0
Total assets	69,849	72,741	86,399	93,536	1,00,847

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20P	FY21E	FY22E
Net income + Depreciation	9,331	11,405	14,166	12,434	15,119
Interest expenses	(96)	(98)	(967)	(437)	(376)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(1,503)	(1,421)	1,370	(5,351)	(1,707)
Other operating cash flows	(404)	(389)	(2,832)	0	0
Cash flow from operations	7,330	9,497	11,737	6,646	13,036
Capital expenditures	(313)	(815)	(1,372)	(1,380)	(1,503)
Change in investments	7,366	5,725	0	0	0
Other investing cash flows	(2,076)	(2,111)	967	437	376
Cash flow from investing	4,977	2,798	(405)	(943)	(1,127)
Equities issued/Others	29	104	0	0	0
Debt raised/repaid	0	0	0	0	0
Interest expenses	(9,877)	(8,867)	0	0	0
Dividends paid	(3,949)	(4,655)	(6,420)	(5,330)	(6,785)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(13,797)	(13,418)	(6,420)	(5,330)	(6,785)
Changes in cash and cash eq.	(1,491)	(1,122)	4,912	374	5,124
Closing cash and cash eq.	4,642	6,572	11,484	11,858	16,982

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20P	FY21E	FY22E
Reported EPS	44.1	57.7	63.7	52.8	67.3
Adjusted EPS	44.1	57.7	63.7	52.8	67.3
Dividend per share	20.0	0.0	28.6	23.8	30.3
Book value per share	283.9	282.0	313.2	337.4	368.2

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20P	FY21E	FY22E
EV/Sales	2.2	1.9	1.7	1.6	1.5
EV/EBITDA	13.7	11.1	9.0	9.8	8.0
Adjusted P/E	18.2	13.9	12.6	15.2	11.9
P/BV	2.8	2.8	2.6	2.4	2.2

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20P	FY21E	FY22E
Tax burden (Net profit/PBT)	74.6	76.3	78.2	75.0	75.0
Interest burden (PBT/EBIT)	115.0	112.8	106.8	103.4	102.3
EBIT margin (EBIT/Revenue)	15.1	16.1	16.0	13.8	16.3
Asset turnover (Revenue/Avg TA)	91.5	108.4	111.1	102.2	103.1
Leverage (Avg TA/Avg Equity)	1.2	1.3	1.4	1.5	1.5
Adjusted ROAE	14.6	20.0	21.4	16.2	19.1

Source: Company, BOBCAPS Research | Note: TA = Total Assets

Ratio Analysis

Y/E 31 Mar	FY18A	FY19A	FY20P	FY21E	FY22E
YoY growth (%)					
Revenue	7.7	18.1	14.4	4.0	8.9
EBITDA	9.7	24.6	24.7	(7.4)	23.8
Adjusted EPS	14.9	30.9	10.4	(17.0)	27.3
Profitability & Return ratios (%)					
EBITDA margin	16.2	17.1	18.7	16.6	18.9
EBIT margin	15.1	16.1	16.0	13.8	16.3
Adjusted profit margin	13.0	13.9	13.4	10.7	12.5
Adjusted ROAE	14.6	20.0	21.4	16.2	19.1
ROCE	13.2	18.0	19.9	15.3	19.0
Working capital days (days)					
Receivables	40	40	33	37	44
Inventory	0	0	0	0	0
Payables	63	75	70	68	69
Ratios (x)					
Gross asset turnover	32.3	39.3	16.3	11.3	14.4
Current ratio	2.1	2.5	2.7	2.8	3.0
Net interest coverage ratio	NA	NA	NA	NA	NA
Adjusted debt/equity	0.0	0.0	0.0	0.0	(0.1)

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

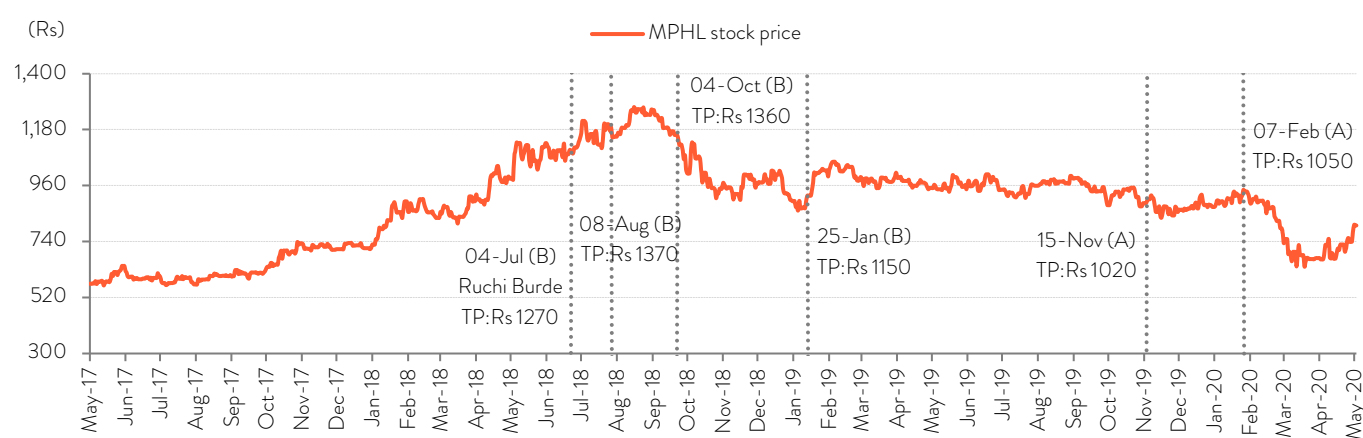
ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

HISTORICAL RATINGS AND TARGET PRICE: MPHASIS (MPHL IN)



B – Buy, A – Add, R – Reduce, S – Sell

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